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RUCPDO/DEPT OF COMMERCE WASHDC
RUEHKO/AMEMBASSY TOKYO 0807
RUEHBJ/AMEMBASSY BEIJING 4316
RUEHBY/AMEMBASSY CANBERRA 1186
RUEHUL/AMEMBASSY SEOUL 4196
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DEPT FOR EAP/MTS AND EB/IFD/OMA
TREASURY FOR IA-SETH SEARLS AND JWEEKS
SINGAPORE FOR SBAKER
TOKYO FOR MGREWE
COMMERCE FOR 4430/BERLINGUETTE
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR TCURRAN
DEPARTMENT PASS EXIM BANK

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SUBJECT: BANK INDONESIA BRIEFS UNDER SECRETARY JEFFERY ON ECONOMY,
BANKING SECTOR

¶1. (SBU) Summary. Two Bank Indonesia (BI) Deputy Governors briefed visiting Under Secretary Jeffery on Indonesia's macroeconomic success in recent years; BI's effort to improve the formal arrangement for managing economic and financial crises; and the central bank's work to prevent large-scale crises from occurring in the future. BI officials also requested additional technical assistance and training from U.S. supervisory authorities. Under Secretary Jeffery congratulated BI on its significant progress in

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improving the soundness of the financial sector and promoting macroeconomic stability in Indonesia. End Summary.

BI Officials Detail Success, Challenges

¶2. (SBU) Deputy Governor for Internal Finance and Central Banking Studies Bun Bunan E.J. Hutapea provided an overview of Indonesia's macroeconomic success in recent years. He noted that the Indonesian economy has finally returned to growth levels experienced prior to the 1997-98 crisis. He enumerated Indonesia's significant successes in maintaining macroeconomic stability over the past two years. Inflation continues to decline, economic growth during the first half of the year rose to 6.1%, foreign exchange reserves stand at \$51 billion, or 5.1 months of imports, the banking sector is strong and the Indonesian financial sector has largely weathered the current volatility in global financial markets. On the expenditure side, strong commodity exports and growing domestic consumption have supported strong GDP growth. On the production side, more robust growth in manufacturing and services have supported strong economic expansion. BI expects strong growth to continue through the remainder of 2007 and into 2008.

¶3. (SBU) BI officials also pointed to Indonesia declining external debt levels, fiscal consolidation and debt swap agreements with other Asian countries as signs of a more stable macroeconomic infrastructure. The GOI has successfully consolidated its fiscal position through the elimination of fuel prices subsidies in 2005, and has maintained a fiscal deficit close to 1% of GDP since that time. As a result, both the size and composition of Indonesia's public debt-to-GDP ratio have improved, allowing the government to

repay its obligation to the IMF in the spring of 2007, ahead of schedule. BI officials also noted that Indonesia has entered into a \$12 billion swap arrangement with Japan, Korea and China to provide liquidity in the event of financial instability. (Note: The Under Secretary pointed out that, given the interconnected nature of

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global financial markets, these arrangements may prove to be of limited use if all parties call on the funds at the same time. End note.)

14. (SBU) Deputy Governor Banking Policy and Financial System Stability Muliawan D. Hadad described BI's effort to improve the formal arrangement for managing economic and financial crises and the central bank's effort to prevent large-scale crises from occurring in the future. On crisis management, BI has worked closely with the Ministry of Finance and other relevant GOI agencies to delineate clearly the responsibility of each body in the event of a crisis. This work has included signing an MOU between BI and the GOI to provide legal standing to these arrangements and the formation of a financial stability forum, which meets regularly at both senior- and working-levels. BI officials report that this apparatus functioned well during the recent global market instability.

15. (SBU) On crisis prevention, BI has focused on building strong banking institutions and financial system integrity as well as developing an early warning system to signal impending financial sector vulnerabilities. According to Deputy Governor Hadad, the 1997-98 crisis revealed governance weaknesses across Indonesia's financial institutions, particularly around related party lending. As a result, BI has focused on improving the risk management and governance capacity of Indonesian banking institutions. BI also is in the process of improving the competitive environment in the Indonesian banking sector. Indonesia's banking sector is highly concentrated, with the 10 largest institutions accounting for the majority of banking sector assets. At the same time, Indonesia has a large number of very small, unsophisticated banking institutions

JAKARTA 00002609 002 OF 002

with limited risk management capacity. According to Hadad, BI's banking architecture reforms are focused on improving competition among large players while consolidating Indonesia's smaller and weaker institutions.

16. (U) In an effort to develop Indonesia's financial sector infrastructure, BI is promoting the creation of a domestic debt-rating agency. BI officials also stated that BI is considering undergoing an International Monetary Fund Financial Sector Assessment Program to develop a blueprint for strengthening and deepening the financial sector. Finally, BI is working to improve the financial education of depositors and investors in an effort to empower the Indonesian population. BI is in the process of developing a dispute settlement mechanism to respond to consumer complaints as well as a mediation process that can resolve these consumer disputes outside of the court system.

BI Seeks U.S. Assistance to Build Supervisory Capacity

17. (U) BI thanked the United States for providing training for its supervisory staff in the post-crisis years. The Federal Deposit Insurance Corporation, the Federal Reserve Bank of New York, and the Board of Governors of the Federal Reserve System have provided BI staff with significant training in risk-focused supervision. However, in an effort to achieve central bank's goal of improving the expertise of supervisory staff, Hadad requested additional assistance from the supervisory authorities in the United States. Deputy Governor Hadad believes Indonesia needs to accelerate supervisory training and reforms in light of ongoing innovation in the financial sector, the need to adopt international accounting standards, and the need to prepare for the introduction of Basel II capital standards.

Under Secretary Applauds BI on Bank Reform, Stability

18. (U) Under Secretary Jeffery congratulated BI on its significant progress in improving the soundness of the financial sector and promoting macroeconomic stability in Indonesia. The Under Secretary pointed to the high quality of BI's staff, the central bank's newly won independence and the strength of BI's regulatory approach as very positive developments. BI officials were particularly interested in the Under Secretary's views on the recent difficulties in the subprime mortgage market in the United States and the U.S. view on the seriousness of the climate change issue.

19. (U) U/S Jeffery cleared on this cable.

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